ST 01-0042-GIL 02/22/2001 COMPUTER SOFTWARE

This letter discusses issues regarding sales of computer software and hardware, nexus, and sale/leaseback transactions. See 86 Ill. Adm. Code 130.1935. (This is a GIL.)

February 22, 2001

Dear Xxxxx:

This letter is in response to your letter dated December 26, 2000. The nature of your letter and the information you have provided require that we respond with a General Information Letter, which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. See 2 Ill. Adm. Code 1200.120 subsections (b) and (c), which can be found at http://www.revenue.state.il.us/legalinformation/regs/part1200.

In your letter, you have stated and made inquiry as follows:

COMPANY is requesting a formal Private Letter Ruling on the applicability of sales tax to the matter described below.

On November 5, 1997, COMPANY sold the following to BUSINESS:

Computer hardware	$ 20,538
NAME software	378,045
Site evaluation and implementation	17,000
Training and consulting services	98,980
Customization of canned software	95,700
Conversion	57,500

COMPANY sells computer hardware, software and services to customers who are located in Illinois. COMPANY is a STATE corporation and does not maintain offices in Illinois. It does have traveling sales and maintenance personnel who may contact customers and/or provide services in Illinois.

BUSINESS is an insurance agency. The NAME software is canned software and was provided to the BUSINESS on disks through the mail. BUSINESS also purchased added functionality. Although this added functionality was termed customization on the invoices, in reality it consisted of computer system set up to allow the canned software to work with the customers existing computer systems. The canned software programming was not changed by the added functionality. The added functionality was billed separately from the canned software. In addition, customers are required to purchase telephone support and maintenance for the duration of their contract. Software was billed separately. The support and maintenance were billed together as one price that also included periodic software updates that were supplied on disk.

BUSINESS also purchased site evaluation, data conversion, and training and consulting. All of these services are billed separately and are not mandatory .

All software sales are evidence by a contract signed by the BUSINESS and COMPANY. The contract forbids the customer from duplicating or reselling the software. If the customer loses their copy of the software, we send them another copy for a $15.00 shipping and handling charge. There is no separate charge for product updates. The contract requires the customer to stop using the software after termination of the contract, however, COMPANY has never attempted to collect any of the software after termination.

BUSINESS purchased computer hardware from COMPANY. BUSINESS then entered into a financing arrangement for the same hardware with a third-party lessor. COMPANY shipped the hardware to the BUSINESS but sent the bill to the leasing company. COMPANY has no relationship with the leasing company other than sending them the bill.

Since the original purchase in 1997, BUSINESS has received monthly billings for support of about $7,800 per month, and several more customization charges.

Please send the Private Letter Ruling to: COMPANY. Questions concerning this matter may be sent to that same address or you can reach me. Your prompt attention to this matter will be greatly appreciated.

The Department is unable to make nexus determinations in the context of a General Information Letter because the amount of information required to make that determination is often best gathered by an auditor. The following information outlines the principles of nexus. We hope it is helpful in determining whether your business is responsible for paying tax in Illinois.

An “Illinois Retailer” is one who either accepts purchase orders in the State of Illinois or maintains an inventory in Illinois and fills Illinois orders from that inventory. The Illinois Retailer is liable for Retailers’ Occupation Tax on gross receipts from sales and must collect the corresponding Use Tax incurred by the purchasers.

Another type of retailer is the retailer maintaining a place of business in Illinois. The definition of a “retailer maintaining a place of business in Illinois” is described in 86 Ill. Adm. Code 150.201(i), enclosed. See also 86 Ill. Adm. Code 150.801, enclosed. The retailer maintaining a place of business in Illinois must collect and remit Use Tax to the State on behalf of the retailer’s Illinois customers even though the retailer does not incur any Retailers’ Occupation Tax liability.

The United States Supreme Court in *Quill Corp. v. North Dakota*, 112 S.Ct. 1904 (1992), set forth the current guidelines for determining what nexus requirements must be met before a person is properly subject to a state’s tax laws. The Supreme Court has set out a 2-prong test for nexus. The first prong is whether the Due Process Clause is satisfied. Due process will be satisfied if the person or entity purposely avails itself or himself of the benefits of an economic market in a forum state. *Quill* at 1910.

The second prong of the Supreme Court’s nexus test requires that, if due process requirements have been satisfied, the person or entity must have physical presence in the forum state to satisfy the Commerce Clause. A physical presence is not limited to an office or other

physical building. Under Illinois law, it also includes the presence of any agent or representative of the seller. The representative need not be a sales representative. Any type of physical presence in the State of Illinois, including the vendor's delivery and installation of his product on a repetitive basis, will trigger Use Tax collection responsibilities. Please refer to *Brown's Furniture, Inc. v. Zehnder*, (1996), 171 Ill.2d 410.

The final type of retailer is the out-of-State retailer that does not have sufficient nexus with Illinois to be required to submit to Illinois tax laws. A retailer in this situation does not incur Retailers' Occupation Tax on sales into Illinois and is not required to collect Use Tax on behalf of its Illinois customers. However, the retailer's Illinois customers will still incur Use Tax on the purchase of the out-of-State goods and have a duty to self-assess their Use Tax liability and remit the amount directly to the State. The Use Tax rate if 6.25%.

Retailers that do not have nexus with Illinois can voluntarily register with the Department for the convenience of their customers. These retailers would collect use Tax from their customers and remit it to the Department.

Generally, sales of "canned" computer software are taxable retail sales in Illinois. See the enclosed copy of 86 Ill. Adm. Code 130.1935. However, if the computer software consists of custom computer programs, then the sales of such software may not be taxable retail sales. See Section 130.1935(c).

Custom computer programs or software are prepared to the special order of the customer. The selection of pre-written or canned programs assembled by vendors into software packages does not constitute custom software unless real and substantial changes are made to the programs or creation of program interfacing logic. See Section 130.1935(c)(3). If the pre-written program or module was previously marketed, the new program will qualify as a custom program if the price of the pre-written program was 50% or less of the price of the new program. If the pre-written program was not previously marketed, the new program will qualify as a custom program if the charge made to the customer for custom programming services, as evidence by the records of the seller, was more than 50% of the contract price to the consumer.

If transactions for the licensing of computer software meet all of the criteria provided in Section 130.1935(a)(1), neither the transfer of the software or the subsequent software updates will be subject to Retailers' Occupation Tax. A license of software is not a taxable retail sale if:

A) it is evidenced by a written agreement signed by the licensor and the customer;

B) it restricts the customer's duplication and use of the software;

C) it prohibits the customer from licensing, sublicensing or transferring the software to a third party (except to a related party) without the permission and continued control of the licensor;

D) the licensor has a policy of providing another copy at minimal or no charge if the customer loses or damages the software, or of permitting the licensee to make and keep an archival copy, and such policy is either stated in the license agreement, supported by the licensor's books and records, or supported by a notarized statement made under penalties of perjury by the licensor; and

E) the customer must destroy or return all copies of the software to the licensor at the end of the license period. This provision is deemed to be met, in the case of a perpetual license, without being set forth in the license agreement.

In general, maintenance agreements that cover computer software and hardware are treated the same as maintenance agreements for other types of tangible personal property. The taxability of maintenance agreements is dependent upon whether the charge for the agreement is included in the selling price of tangible personal property. If the charge for a maintenance agreement is included in the selling price of tangible personal property, that charge is part of the gross receipts of the retail transaction and is subject to Retailers' Occupation Tax liability. No tax is incurred on the maintenance services or parts when the repair or servicing is completed.

If maintenance agreements are sold separately from tangible personal property, the sale of the agreement is not a taxable transaction. However, when maintenance services or parts are provided under the maintenance agreement, the company providing the maintenance or repair will be acting as a service provider under the Service Occupation Tax Act. The Service Occupation Tax Act provides that when a service provider enters into an agreement to provide maintenance services for a particular piece of equipment for a stated period of time at a predetermined fee, the service provider incurs Use Tax based upon its cost price of tangible personal property transferred to the customer incident to the completion of the maintenance service. See 86 Ill. Adm. Code 140.301(b)(3), enclosed.

Charges for updates of canned software are fully taxable pursuant to Section 130.1935. If the updates qualify as custom software under Section 130.1935(c), they may not be taxable. But, if maintenance agreements provide for updates of canned software, and the charges for those updates are not separately stated and taxed, then the whole agreement would be taxable as sales of canned software.

Assuming that the services provided, such as installation, phone support, and training do not require the transfer of tangible personal property to the recipients of those services, charges for such services are exempt if they are separately stated from the selling price of canned software. See Section 130.1935(b). If computer software training or other support services are provided in conjunction with a sale of custom computer software or a license of computer software, the charges for that training are not subject to tax.

Retailer's Occupation Tax and Use Tax do not apply to receipts from sales of personal services. Under the Service Occupation Tax Act, servicemen are taxed on tangible personal property transferred incident to sales of service. For your general information we are enclosing a copy of 86 Ill. Adm. Code 140.101 regarding sales of service and Service Occupation Tax.

The purchase of tangible personal property that is transferred to service customers may result in either Service Occupation Tax liability or Use Tax liability for the servicemen, depending upon which tax base the servicemen choose to calculate their liability. Servicemen may calculate their tax base in one of four ways: (1) separately stated selling price; (2) 50% of the entire bill (3) Service Occupation Tax on cost price if they are registered de minimis servicemen; or, (4) Use Tax on cost price if the servicemen are de minimis and are not otherwise required to be registered under Section 2a of the Retailers Occupation Tax Act.

The State of Illinois taxes leases differently for Retailers' Occupation Tax and Use Tax purposes than the majority of other states. For Illinois sales tax purposes, there are two types of leasing situations: conditional sales and true leases.

A conditional sale is usually characterized by a nominal or one dollar purchase option at the close of the lease term. Stated otherwise, if lessors are guaranteed at the time of the lease that the leased property will be sold, this transaction is considered to be a conditional sale at the outset of the transaction, thus making all receipts subject to Retailers' Occupation Tax.

A true lease generally has no buy out provision at the close of the lease. If a buy out provision does exist, it must be a fair market value buy out option in order to maintain the character of the true lease. Lessors of tangible personal property under true leases in Illinois are deemed end users of the property to be leased. See the enclosed copy of 86 Ill. Adm. Code 130.220. As end users of tangible personal property located in Illinois, lessors owe Use Tax on their cost price of such property. The State of Illinois imposes no tax on rental receipts. Consequently, lessees incur no tax liability.

The above guidelines are applicable to all true leases of tangible personal property in Illinois except for automobiles leased under terms of one year or less, which are subject to the Automobile Renting Occupation and Use Tax found at 35 ILCS 155/1 et seq.

As stated above, in the case of a true lease, the lessors of the property being used in Illinois would be the parties with Use Tax obligations. The lessors would either pay their suppliers, if their suppliers were registered to collect Use Tax, or would self-assess and remit the tax to the Department. If the lessors already paid taxes in another state with respect to the acquisition of the tangible personal property, they would be exempt from Use Tax to the extent of the amount of such tax properly due and paid in such other state. See 86 Ill. Adm. Code 150.310(a)(3), enclosed.

Under Illinois law, lessors may not pass their tax obligation on to the lessees as taxes. However, lessors and lessees may make private contractual arrangements for a reimbursement of the tax to be paid by the lessees.

In sale/leaseback situations, typically user A, purchases equipment from retailer B. User A sells the equipment to lessor C and lessor C then leases the equipment back to user A.

The first transaction (the sale from retailer B to user A) is a taxable retail sale. The second transaction (the sale from user A to lessor C) is a nontaxable occasional sale so long as user A is not otherwise engaged in the business of selling like-kind property. The third transaction (the leaseback of the equipment from lessor C to user A) is not taxable because Illinois does not impose sales tax liability on rental receipts (the only exception is receipts from the rental of automobiles under lease terms of one year or less).

No special documentation is required for any of the transactions. In transaction 1 (the sale from retailer B to user A), retailer B would include the gross proceeds from its sale to user A on its monthly sales tax return and user A would retain an invoice showing that it paid tax to retailer B. In transaction 2 (the sale from user A to lessor C), it may be wise to document, on the invoice to lessor C, the fact that user A is not in the business of selling like-kind equipment and that the sale is a nontaxable occasional sale. In transaction 3 (the leaseback from lessor C to user A) no documentation is required because rental receipts are not subject to Illinois sales tax liability (with the exception stated above of receipts from the rental of automobiles under lease terms of one year or less).

The sale/leaseback transaction is not generally used with a conditional sale transaction because there is no statutory mechanism to provide a credit for tax previously paid by user A. Ultimately if a sale/leaseback is used in conjunction with a conditional sale, user A will be liable for

tax when the equipment is purchased and again when lessor C conditionally sells the equipment back to A. To avoid this result user A would need to lease the equipment from C under a true lease rather than a conditional sale.

I hope this information is helpful. The Department of Revenue maintains a Web site, which can be accessed at www.revenue.state.il.us. If you have further questions related to the Illinois sales tax laws, please contact the Department's Taxpayer Information Division at (217) 782-3336.

If you are not under audit and you wish to obtain a binding Private Letter Ruling regarding your factual situation, please submit all of the information set out in items 1 through 8 of the enclosed copy of Section 1200.110(b).

Very truly yours,

Martha P. Mote
Associate Counsel

MPM:msk
Enc.